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Before the
Federal Communications Commission
Washington, DC 20554

In the Matter of Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
	)	

COMMENTS OF AIRTOUCH COMMUNICATIONS, INC. ON FEDERAL-STATE JOINT BOARD RECOMMENDED DECISION

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AirTouch Communications, Inc. ("AirTouch")[1] hereby submits the following comments regarding the Federal-State Joint Board's recommended decision in the above-captioned proceeding.[2]

I. SUMMARY

The Commission is at an historic crossroads in universal service reform. It has the opportunity to re-engineer a costly and ineffective system of taxes and subsidies into one that serves the interests of American citizens. At the same time, there is a danger that the wrong policy decisions will perpetuate the waste and inefficiency inherent in the current system. Indeed, there is a significant risk of making these problems worse by expanding the system and unfairly increasing the tax burdens levied on all telecommunications subscribers.

The Joint Board's universal service recommendations constitute a potentially huge, unquantified tax on telecommunications consumers and service providers for a number of reasons:

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1 AirTouch is a wireless communications company with interests in cellular, paging, personal communications services, satellite and other operations.

2 *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, FCC 96J-3, *RD* (rel. Nov. 8, 1996) ("*RD*").

- Preliminary analysis of the *RD* indicates that the resulting fund contributions to pay for federal programs alone could range from 6 to 12 percent of all total intrastate and interstate service revenues. It is important to note that these figures omit any taxes levied on telecommunications consumers by states to fund their universal service programs, so that the total burden faced by consumers would be even higher.

- The estimated efficiency losses associated with these taxes range from approximately $1 to over $6 billion annually. These losses in consumer and provider welfare are *above and beyond the direct costs of the taxes themselves*. In other words, if raising tax revenues of $19 billion generates efficiency losses of $6 billion, then the total welfare loss suffered by the tax payers is $25 billion.

The Commission should take several steps to reduce the size of these efficiency losses and the resulting harm to telecommunications consumers:

- The subscriber line charge should be moved toward cost-based levels. Generally this will entail raising this charge, not lowering it. Empirical studies demonstrate that lowering the subscriber line charge as suggested in the *RD* may well reduce subscribership, not promote it. This negative effect flows from the changes in other rates needed to offset the reduction in the subscriber line charge. As the Commission itself has concluded in other proceedings, consumer interests and competition are best promoted when the rate structure tracks the pattern of cost causation (*i.e.*, one in which loop costs are recovered through flat-rate charges).

- The Commission should avoid creating additional universal service obligations without strong evidence that the benefits outweigh the costs. Subsidies for inside connections for schools and libraries, as well as subsidies for single-line businesses, do not meet this test.

- The Commission should make use of market-based incentives to hold down the costs of universal service support programs and thus reduce the costs borne by all telecommunications consumers. The Commission should adopt the Joint Board's recommendation to rely on forward looking economic costs, not embedded costs, as the basis of calculating required universal service subsidy levels. The Commission should adopt a proxy model to cap support payments and should commence a proceeding to design and implement auctions.

- The Commission should coordinate federal and state universal service benefits and taxation to avoid placing inefficient, overly burdensome, and discriminatory taxes upon telecommunications carriers.

II. INTRODUCTION

The Joint Board's *RD* makes significant contributions to the public discussion of universal service policy. Unfortunately, the *RD* also proposes a variety of expensive initiatives without providing even a rudimentary analysis of the negative effects that the resulting taxes will have on consumer welfare. AirTouch strongly supports Commissioner Chong's view that policy makers "need to carefully consider the impact on all consumers before [they] expand the scope of the funding obligation."[3] Sound policy analysis, including an examination of the consumer welfare costs of proposed programs, is vital to a rational universal service policy. The Commission must base its decisions on clear thinking, economic logic, and empirical analysis.

These comments address the present lack of sound economic analysis by offering some preliminary calculations of the negative and unwarranted effects of the Joint Board's recommendations on telecommunications consumers. This analysis demonstrates that the burdens placed on telecommunications service providers and subscribers to fund the proposed universal service programs will be significant and will give rise to large efficiency losses. In fact, the result of these policies may be to harm many of the very consumers universal service programs are supposed to assist.

There are several steps that the Commission can, and should, take to reduce the economic harm to telecommunications service subscribers and providers. The Commission should act to ensure that universal service programs are no larger, and no more costly, than

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[3] *See RD*, Separate Statement of FCC Commissioner Rachelle B. Chong 6 (rel. Nov. 7, 1996)("Chong Separate Statement").

absolutely necessary to achieve their policy goals. The Commission should raise, not lower, the subscriber line charge. Empirical studies show that lowering the subscriber line charge and raising other, traffic-sensitive charges to finance this reduction will distort consumption levels and may well *lower* subscribership.

In light of the efficiency costs of raising subsidies, the Commission should avoid overly broad universal service programs. The Commission should refrain from taxing telecommunications subscribers to subsidize inside connections for schools and libraries or to subsidize single line business subscribers. In each case, the costs of the subsidies outweigh the benefits.

Finally, the Commission should ensure that universal service providers receive subsidies no longer than needed. A system under which a carrier is subsidized based on claimed embedded costs overstates the amount to which the universal service provider should be entitled and generates little incentive for cost reduction. Instead, the Commission should introduce market incentives and implement regulatory schemes that mimic competitive markets wherever possible. Any subsidy payments made directly to carriers should be based on either: (1) proxy cost model estimates of forward-looking economic costs, or (2) competitive bidding to be the universal service provider. AirTouch submits that each of these recommendations is fully consistent with the mandates of Section 254 of the Telecommunications Act of 1996 ("1996 Act"),[4] and should be adopted by this Commission.

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[4] Pub. L. No. 104-104, 110 Stat. 56 (1996). The 1996 Act substantially amends the Communications Act of 1934 codified at 47 U.S.C. §§ 151 *et seq.* Hereinafter, all citations to the 1996 Act will be to the United States Code.

III. UNIVERSAL SERVICE REFORM SHOULD NOT BE USED TO LEVY MASSIVE TAXES THAT WILL HARM CONSUMERS AND ECONOMIC EFFICIENCY

Universal service subsidies do not come free. Either implicit or explicit taxes will have to be levied on telecommunications service providers and consumers to fund the subsidies. There are two types of economic costs associated with these taxes. First, there is the direct cost of the taxes. For every dollar of subsidy granted to one firm or household, a dollar has to be taken away from another. Inevitably, a second cost arises as well: the imposition of a tax distorts providers' investment and supply decisions and subscribers' consumption decisions, and thus gives rise to efficiency losses. These efficiency costs are *in addition* to the direct income losses that consumers suffer from bearing the tax burdens. These efficiency costs are referred to by economists as the *deadweight loss* of taxation because they represent costs for which there are no offsetting benefits.[5]

These distortions will arise for two reasons:

- Prices will be further elevated above incremental costs. Prices above incremental costs suppress consumption below efficient levels. When prices exceed incremental costs, there are consumers who choose not to make calls for which the value to the subscriber exceeds the incremental cost of the call but is less than the price faced by the subscriber.

- The best efforts of policy makers notwithstanding, universal service programs will violate the important principle of competitive neutrality. Both fund collection and disbursement will have uneven effects across telecommunications carriers due to asymmetries between carriers. For example, subsidizing service areas, rather than individual subscribers, tends to favor incumbent providers who already have broad coverage. Similarly, a revenues tax favors wireline carriers over wireless. Carriers using higher cost technologies that offer premium services are put at a disadvantage

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[5] In contrast, the taking a dollar from one subscriber and giving it to another is referred to as a *pure transfer* because there is a dollar benefit to the recipient that offsets the dollar cost to the other consumer.

by a revenues tax, which place a greater tax per-minute on their calls.[6] Ultimately, it is impossible to attain complete competitive neutrality short of moving to a system of vouchers funded as part of the overall U.S. federal tax system.

Important policy conclusions follow from the existence of deadweight losses. First, the Commission should recognize that there are efficiency costs of universal service programs above and beyond the resources spent directly providing the services themselves. These costs must be taken into consideration when choosing whether to expand federal universal service programs and trigger additional costs. Second, because deadweight losses are costs that have no offsetting benefits, universal service policy should be designed to minimize deadweight losses and maintain competitive neutrality.

A. Projected Universal Service Tax Rates

It is unsettling that the Federal-State Joint Board reached its broad ranging recommendations without any meaningful discussion of the magnitude of the taxes that their proposals would entail. The following sample calculations, while necessarily approximate, give a reasonable indication of the magnitude of the taxes involved. These calculations are the first step in what AirTouch believes should be an extensive process of analysis that should be undertaken by this Commission in revising universal service programs.

To calculate the tax rate, the revenue need should be divided by the tax base. Thus, the first step is to project both the size of the universal service funding obligations and the base on which the tax will be collected.

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[6] For a more complete discussion of the inefficiencies and competitive non-neutrality of revenues-based taxes, *see* AirTouch Further Comments at 13-15.

Revenue Needs. The new universal service fund will need to cover three main categories of expenses: subsidies for high-cost areas, subsidies for low-income subscribers, and subsidies for schools, libraries, and rural hospitals. For high-cost support, we have taken the sample amounts included in the *RD.* At a $20.00 benchmark, using the model's default settings, the Hatfield model indicates that the universal service support (high-cost support) would be $5.3 billion. The BCM2, at a $20.00 benchmark, indicates that support would be $14.6 billion.[7]

Support for schools and libraries is capped at $2.25 billion in the *RD.* We have included a range amount from $1 billion to $2.25 for rural hospitals. While there are many fewer rural hospitals than there are schools, they may require more advanced services that entail higher costs for provision.

AirTouch's estimates of the tax revenue requirements are presented in the table below:

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[7] *RD*, Appendix F, ¶18.

Tax Revenue Requirements

Category	**Estimate** (in billions)
High-Cost Fund	
($20 affordability criterion)	$5.3 to $14.6
Low-Income Subscribers	
Lifeline[8]	$0.31
Link-Up America[9]	$0.02
Institutional Assistance	
Schools and Libraries	$2.25
Rural Health Care Providers	$1 to $2.25
Total	$8.88 to $19.43

Tax Base. There are several issues related to the choice of tax base, including whether it should be based on lines, minutes, gross revenues, or net revenues, and whether to include all traffic or solely interstate traffic. The Joint Board recommends that the tax base for the schools, libraries and health care providers support be levied on both intrastate and interstate net revenues of providers of interstate telecommunications services. The Joint Board did not recommend a suitable tax base for the high cost fund or the low-income

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[8] The Joint Board proposes to raise the federal contribution to $5.25, to be matched by the states. According to the 1995 Monitoring Report (Table 2.3), there were 4,913,947 subscribers receiving Lifeline assistance in 1995. Multiplying $5.25 per subscriber per month by 12 months per year by 4,913,947 subscribers yields an estimated federal Lifeline revenue requirement of $309,578,661 per year.

[9] 1995 Monitoring Report, Table 2.2.

assistance fund, simply stating that they found it would be premature to conclude whether the base should be interstate revenues or a combination of interstate and intrastate revenues.[10]

In order to reduce the number of cases to consider, the calculations below assume that the tax base is both intrastate and interstate net revenues. AirTouch has, using Commission data, constructed estimated total intrastate and interstate telecommunications services revenues broken down into two broad categories corresponding to: (a) local services; and (b) long distance and wireless. Because the tax based used in these projections is net revenues, these figures have been adjusted where possible to avoid double counting access charges paid by long distance companies to local exchange carriers. These estimates are presented in the table below:[11]

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10 *RD* at ¶ 821.

11 Because of the way the numbers are reported by the Commission in *Statistics of Common Carriers*, the local service revenue amount includes charges for basic monthly service, state and federal end user charges, and access charges levied on intrastate long-distance carriers. The long distance and wireless revenue amount represents the long distance service revenues collected by interstate telecommunications carriers reporting the Commission. The resulting total figure omits intrastate carriers' long distance revenues. However, these wireless revenues, as calculated in the 1994 TRS Fund Worksheet, are unlikely to be large enough to make significant differences in the resulting projected tax rates and deadweight losses.

Size of the Tax Base

Service Category	**1995 Revenue** (in billions)
Local +	$58.026
Long Distance and Wireless	$97.539
Total	$155.565

Projected Tax Rates. Using the assumptions presented above, the projected tax rates range from a low of 6 percent to a high of 12 percent when both intrastate and interstate revenues are taxed. It also is important to note that these estimates do not include any taxes levied on telecommunications consumers by states to fund their universal service programs. Thus, the tax burdens levied on telecommunications providers and subscribers would be larger than estimated here and below.

B. Estimates of Potential Welfare Losses

Having projected a range of potential tax rates, it is possible to calculate the deadweight losses associated with these taxes. While the projected deadweight loss is dependent on the particular assumptions made, the estimates presented here are reasonable assumptions and range from almost $1 billion annually to over $6 billion annually. As stated earlier, these losses in consumer welfare are *above and beyond the direct costs of the taxes themselves.*

A shown in the Appendix to these comments, the formula for deadweight loss of taxation is:

$$(\tfrac{1}{2}\ tax\ rate + Lerner\ index) \times tax\ rate \times \frac{elasticity}{of\ demand} \times service\ revenue$$

Tax Rates. As discussed earlier, AirTouch's preliminary estimate of the tax rate ranges from 6 percent to 12 percent.

Lerner Index. The Lerner index is the price-cost margin expressed as a percentage of price: $(p-c)/p$, where p is the price per unit of service and c is the marginal cost of a unit of service). Estimates of the Lerner index for AT&T (several of which were submitted in the AT&T nondominance proceeding) range from .1 to over .5.[12] However, other factors may require adjusting the Lerner index upward.[13]

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[12] *See, e.g.*, Michael R. Ward, "Measurements of Market Power in Long Distance Telecommunications," Federal Trade Commission, April 1995; Simran K. Kahai, David L. Kaserman, and John W. Mayo, "Is the 'Dominant Firm' Dominant? An Empirical Analysis of AT&T's Market Power," unpublished manuscript, January 1995. Paul W. MacAvoy, "Tacit Collusion by Regulation: Pricing of Interstate Long-Distance Telephone Services," Yale School of Management Working Paper Series C, #37, November 1994.

[13] The relevant price-cost margin for the present purposes of deadweight loss calculation is the difference between the price that telecommunications subscribers pay and the true underlying costs of production. Since the access charges that AT&T pays are significantly greater than the costs of access, the relevant margin for tax analysis is greater than the difference between AT&T's service prices and the marginal costs that it faces as a firm. For example, if terminating and originating access charges each were 2 cents per minute above incremental costs, then the Lerner index would have to adjusted upward by .25 on a call with a retail price of 16 cents per minute.

Similarly, state universal service taxes would have the effect of increasing the Lerner

(continued...)

Elasticity of Demand. AirTouch has calculated the deadweight loss solely for the effects on the demand for long distance and wireless services. There would also be distortions in the components of local service, but these are being ignored, which biases the projected deadweight losses downward toward zero. This is done because empirical studies show that consumer decisions to connect to the local network are insensitive to price. Conventional estimates of the elasticity for toll services range from .4 to .72 in absolute value.[14]

Service Revenue. As noted above, the present analysis calculates deadweight loss solely for long distance and wireless services.

Projected Deadweight Loss. AirTouch's projected deadweight loss calculations are presented in the table below:

(...continued)

index since they are part of the margin between the price consumers pay for the service and the true resource cost of providing the service. The welfare effects of state-levied taxes to support universal service programs are discussed below. *See infra* text at 28-29.

[14] The lower range corresponds to estimates for intraLATA toll (*see*, for example, Kenneth E. Train, "IntraLATA Toll Elasticities," *Telecommunications Policy*, December 1993, pp. 707-714), while the higher end corresponds to estimates for interLATA toll (*see*, for example, Lester D. Taylor, *Telecommunications Demand in Theory and Practice*, Dordrecht: Kluwer Academic Publishers, 1994, p. 147). AirTouch believes, however, that the price elasticity of demand may be even greater for wireless services.

Deadweight Loss

Tax Rate	.06	.09	.12
Elasticity	.4	.56	.72
Lerner Index	.3	.5	.7
Deadweight Loss (billions per year)	$0.773	$2.679	$6.405

C. Summary of the Analysis

The Joint Board's recommended universal service policies would significantly suppress the demand for toll and wireless telecommunications services and thus give rise to large efficiency losses suffered by telecommunication services consumers and providers. Yet there will be few benefits in terms of penetration. As discussed in the next section, after accounting for the resulting increase in other rates, subscribership may actually be lowered by the current policy of lowering the SLC.[15] Unlike the subscribership decision, the demands for long distance and wireless services are sensitive to price, and therefore will be distorted by the universal service taxes.

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[15] The summary conclusions presented here reflect the fact that it is inefficient to increase the prices of relatively elastic services (*e.g.*, long distance and wireless) in order to decrease the prices of relatively inelastic services (*e.g.*, local exchange). The deadweight loss calculations presented here are consistent with the efficiency losses found by Crandall and Waverman. They found that rebalancing residential local, business local, and long distance prices to conform more closely with economic principles would generate an annual welfare gain of $8 billion. Robert W. Crandall and Leonard Waverman, *Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications*. Washington, D.C.: The Brookings Institution, 1995, p. 93.

IV. THE COMMISSION MUST INCREASE THE SUBSCRIBER LINE CHARGE TO COST-BASED LEVELS

The Joint Board recommends lowering the subscriber line charge ("SLC") even in those areas where the SLC is already below cost.[16] The Joint Board offers no empirical evidence to support its recommendation and no analytical framework within which to address the relevant issues.[17] The reason for this lack of support is that there are, in fact, no data to back it up and the implicit analytical view is illogical. Commission Chong summarized the matter succinctly in her separate statement:

> [T]he Joint Board's recommendation to reduce the SLC is bad economic policy that contradicts the Commission's long-standing goal to promote economic efficiency and cost causation. The SLC is a non-traffic sensitive charge that recovers non-traffic sensitive costs in the most economically efficient manner from end users.[18]

The Commission itself reached a similar conclusion in its recent decision in the Local Competition Proceeding. As the Commission stated in the Notice of Proposed Rule Making in that proceeding and affirmed in its First Report and Order:

> In general, we believe that costs should be recovered in a manner that reflects the way they are incurred. ... Dedicated facilities are those that are used by a single party -- either an end user or an interconnecting network. ...The cost of a dedicated facility can be attributed directly to the party ordering the service that uses that facility, and it is therefore efficient for that party to pay charges that recover the full cost of the facility. A non-traffic sensitive (NTS) or "flat-rated" charge is most efficient for dedicated facilities, because it ensures that a customer will pay the full cost of the facility, and no more. It ensures that the customer will, for example, add additional lines only if the

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16 *See RD* at ¶¶ 769, 773.

17 *Id.*

18 Chong Separate statement at 11-12 (footnotes omitted).

> customer believes that the benefits of the additional lines will exceed their cost. It also ensures that the customer will not face an additional (and non-cost-based) usage charge.[19]

AirTouch submits that the Commission's economic and policy analysis in the Local Competition Proceeding compels it, in this proceeding, to move SLC to a cost-based level and rate structure. Consistent with the Commission's analysis in the Local Competition Proceeding, reducing the SLC would distort consumption and harm consumers, and is therefore not in the public interest.

Moreover, it is difficult to see how the Commission can rationalize forcing the states to adopt principles of cost-causative pricing for interconnection, while disavowing their applicability in an entirely analogous situation. The fundamental economic principles embraced in the Local Competition Proceeding are not overridden by universal service concerns. As the empirical studies discussed below demonstrate, there are unlikely to be subscribership gains from a reduction in the SLC to offset the economic losses triggered by the failure to have a rate structure that mirrors the underlying pattern of cost causation. Indeed, the inefficiencies engendered by such a policy may do more to threaten the goal of universal telecommunications subscribership than to promote it.

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[19] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, FCC 96-182, CC Docket No. 96-98, 11 F.C.C.R 14171, 14223 (rel. April 19, 1996).

Hausman, Tardiff, and Belinfonte[20] estimate the elasticity of access with respect to service prices. They demonstrate that focusing solely on the price of basic access leads to incorrect conclusions about the effects of rebalancing telephone service prices. Their analysis finds that toll rates also affect subscribership decisions. "Thus, an increase in basic access prices combined with a decrease in long-distance toll prices...could well lead to an *increase* in telephone penetration...."[21] At the most fundamental level, this finding simply reflects the fact that reducing one rate necessitates raising others. In the end, consumers pay just as much for telecommunications services when the SLC is low as when it is high, but consumers' purchasing decisions are distorted when the SLC is below cost. The end result is inefficiency which decreases the net benefits derived from the consumption of telecommunications services. [22]

As Hausman, Tardiff, and Belinfonte discuss, when the SLC was instituted, many consumer advocates predicted that large numbers of households would drop off the network.

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20 Jerry Hausman, Timothy Tardiff, and Alexander Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *American Economic Review* 83:2, 178-184.

21 Hausman et. al., at 182.

22 Interestingly, the existence of network externalities (whereby the benefits that one subscriber derives from connection to the public switched telephone network rises with the number of other subscribers) may provide an additional reason to move the SLC to cost-based levels. If all consumers are identical, then a two-part tariff with a marginal price equal to marginal cost and a lump-sum fee set to cover fixed costs maximizes net consumer benefits and, thus, penetration rates. These forces continue to operate in the more realistic case with heterogeneous consumers. The fallacy in the argument that lowering the SLC will increase penetration and confer positive network effects is that it ignores that need to finance the below-cost pricing by raising other telecommunications service prices.

In fact, from 1984 to 1990, penetration increased from 91.4 percent to 93.3 percent. "The results are consistent with the fact that even low-income customers pay a substantial portion of their monthly bill for toll services. For example, using a sample of actual May 1991 bills from Pacific Bell for California, we calculate that toll calls account for 64.9 percent of the total bill."[23] It is not true that low-income subscribers do not make toll calls and therefore care only about low access prices.[24]

Wolak[25] uses household-level data from the Consumer Expenditure Survey (1988-1991) to estimate a complete system of consumer demand functions for local and long-distance service, food, clothing, and other non-durable goods. He accounts for both income effects and cross-price elasticities between all goods, making his the most general demand structure ever estimated for telecommunications services. He conducts simulations in which the price of local service is raised significantly while the price of long-distance service is lowered by an equal percentage. In each case, he concludes that subscribership would not be harmed and that average consumer welfare increases.

There is a second reason that lowering the SLC would harm the public interest. In addition to violating principles of cost-causative pricing, lowering the SLC would violate economic principles of efficient taxation. It is a well-established principle of public finance

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23 Hausman et. al., at 183

24 In the non-dominance proceeding, AT&T presented data indicating that the level of long distance calling is relatively insensitive to subscriber income levels.

25 Frank A. Wolak, "Can Universal Service Survive in a Competitive Telecommunications Environment? Evidence from the U.S. Consumer Expenditure Survey," mimeo, Feb. 1991.

economics that policy makers should rely on lump-sum taxation to the extent feasible.[26] A pure lump-sum tax (or one that depends on taxpayer characteristics that are beyond his or her control) is efficient because the person on whom it is levied can do nothing to affect the amount, and thus there is no incentive for the taxpayer to distort his or her actions. Of course, the SLC is not a perfect lump-sum tax; a household can avoid it by disconnecting from the public switched telephone network. But, as just discussed, the elasticity of demand for subscription is very low. Hence, this near-lump-sum tax would be a desirable way to raise revenues to support universal service subsidies. Similarly, because they show relatively high price elasticities of demand for toll services, empirical studies support the conclusion that it is not sound policy to raise universal service subsidies by taxing toll services.

V. THE COMMISSION SHOULD NOT EXPAND UNIVERSAL SERVICE SUPPORT TO COVER SERVICES, SUCH AS INSIDE CONNECTIONS FOR SCHOOLS AND LIBRARIES, FOR WHICH THE COSTS EXCEED THE BENEFITS AND FOR WHICH THERE IS NO STATUTORY MANDATE

A. Subsidizing Inside Connections for Schools and Libraries will Trigger Taxes that Lower Consumer Welfare

The Joint Board's recommendation to include connections to classrooms and related hardware on the list of "services" eligible for universal service support[27] represents an unwarranted departure from Commission precedent. AirTouch demonstrated in its Further Comments that neither the language nor the legislative history of Section 254(h) support the conclusion that Congress intended that internal connections should be eligible for universal

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26 *See* AirTouch Reply Comments at 16.

27 RD at ¶ 473.

service support.[28] Furthermore, as Commissioner Chong has aptly noted, it is well-established under Commission precedent that "there is a difference between (1) the telecommunications and information services repeatedly referenced in the statute, and (2) telecommunications facilities, such as [inside wiring and CPE]."[29] Section 254(c) expressly limits universal service support to "telecommunications services," and Sections 254(c)(3) and 254(h) similarly restrict educational providers' and libraries' eligibility for discounts for "services."[30] In addition, the Section 254(h)(2) "access" requirement is consistent with this long-standing Commission precedent.

Section 254(h)(2)(A) requires the Commission to establish "competitively neutral rules . . . to enhance, *to the extent technically feasible and economically reasonable*, access to advanced telecommunications and information services for all public and nonprofit elementary and secondary school classrooms, health care providers and libraries."[31] AirTouch submits that requiring telecommunications providers to fund internal connections is not economically reasonable, and therefore contravenes this statutory requirement.

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28 Further Comments of AirTouch at 9-12.

29 *See* Chong Separate Statement at 6 (citing *NARUC v. FCC*, 880 F.2d 455, 425 (D.C. Cir. 1989).

30 47 U.S.C. §§ 254(c), (h); *see also* Chong Separate Statement at 6-7. AirTouch also notes that the Joint Board itself referred to "telecommunications services" and "internal connections" separately. *RD* ¶ 629 ("[W]e recommend that the Commission use section 254(h) to provide universal service support to schools and libraries for *telecommunications services*, Internet access, *and internal connections*."(emphasis added)).

31 47 U.S.C. § 254(h)(2)(A) (emphasis added).

AirTouch established in its Further Comments the economic reasons to exclude inside connections from universal services support.[32] AirTouch noted that it will only make sense to promote the purchase of telecommunications services if the subsidized entities can put together the complete packages of services, equipment (including computers and other non-telephone terminal equipment), and training needed to generate significant educational benefits.[33] The cost of providing facilities and equipment, however, is estimated to be in the billions of dollars. Telecommunications providers will likely recoup these costs by raising rates.

Mandating that carriers provide significant discounts for inside connections is also likely to place significant burdens upon other consumers. The market for internal connections is unregulated and highly competitive, and providing significant discounts for inside connections is likely to place significant burdens upon other telecommunications consumers; both the direct burdens of the taxes used to fund such subsidies and in indirect efficiency costs that will be triggered by the collection of such subsidies.[34] Moreover, as Commissioner Chong has noted, such discounts may "unintentionally skew the efficient working of the market by inducing a library or school to choose a less efficient internal

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32 *See* Further Comments of AirTouch at 9-12.

33 *See id.*

34 As AirTouch explained in its Further Comments, unlike the costs associated with common network elements, the costs of inside connections are entirely incremental costs. Given that the provision of inside connection is open to competition, it may already be sold at close to its incremental cost. Consequently, there may be no way to provide reduced prices to schools and libraries without pricing below long-run incremental cost, resulting in cost shifts to other consumers. *See id.*

connection alternative."[35] Finally, the *RD*'s reliance on the term "access" to justify supporting interior connections is a "slippery slope"[36] providing no fundamental standard to judge what equipment or services should or should not be supported.

Thus, to ensure that it meets the statutory objective of promoting "[q]uality services . . . available at just, reasonable, and affordable rates" while "enhanc[ing] access to advanced telecommunications and information services" in an economically reasonable manner, the Commission should first make certain that its universal service support requirements can fund those telecommunications services expressly required by the statute.[37] For these reasons, in addition to those provided in AirTouch's Further Comments, funding for internal connections should come from general taxes, not those levied specifically on the telecommunications sector.

B. There is no Sound Public Interest Rationale for Subsidizing Single-line Business Customers

The Joint Board recommends making universal service support available for designated telecommunications services carried to single-connection businesses in high cost areas.[38] However, no empirical support is provided in the *RD* to support the claim that single line business owners would find unsubsidized costs "prohibitive." Moreover, there is no attempt to quantify the costs and benefits of a such a policy.

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35 Chong Separate Statement at 4-5.

36 *Id.* at 7.

37 *See id.* at 5, 8.

38 *RD* at ¶ 91.

Business users, unlike residential users, can deduct the costs of telecommunications services from their income taxes, reducing the net cost of these services. Moreover, the choice of business telecommunications services is a commercial decision. If telecommunications services are vital to a business, there is little reason to believe that its owners would not choose to purchase the service.

At a minimum, in those cases where a business line is the second line into a home, the Commission should adopt of the Joint Board's recommendation that no subsidy is allowed. In such a situation, a business could meet its health and safety needs by sharing the residential line.

VI. MARKET FORCES SHOULD BE USED TO PROMOTE THE EFFICIENT ALLOCATION AND USE OF UNIVERSAL SERVICE SUPPORT

Universal service policy will serve the public interest only if it contains incentives for efficiency and cost reduction. A system under which a carrier is subsidized on a cost-plus or rate-of-return basis is fatally flawed because it provides little incentive for efficient cost reduction. It would be neither sound policy, nor consistent with the spirit of the 1996 Act, to support universal service on a traditional cost-of-service basis. Instead, the Commission should introduce market incentives and regulatory schemes that mimic competitive markets wherever possible. Hence, any subsidy payments directly to carriers should be based either on: (1) proxy cost models that create price-cap like incentives, or (2) the results of competitive bidding to be the universal service provider for the relevant end users.

A. Proxy Model Estimates of Forward Looking Economic Costs Should be Used to Cap Universal Service Support Payments

Use of a proxy model to calculate universal service support will promote efficiency while providing sufficient incentive to support infrastructure development and maintain quality service.[39] As the Joint Board correctly concluded, such a model should attempt to estimate the forward looking economic costs of service.

AirTouch submits further that any model or data on which the Commission bases support payments should be publicly accountable and verifiable. Universal service support funds will largely go to the ILECs and, to date, the support funds have largely come from other carriers. Hence, ILECs have strong economic incentives to overstate their support needs. If the ILECs want to receive large universal service subsidies, then they should be compelled to produce verifiable data showing that they have incurred the underlying costs. Otherwise the effect of universal service policy may be to serve as a means for ILEC shareholders to tax other telecommunications carriers and their customers.

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[39] The Joint Board did not recommend a particular model but stated that "[w]e conclude that the BCM2 and the Hatfield Model Version 2.2. Release 2 (Hatfield Model) are the best available basis for future development of an acceptable proxy model at this time." *RD* at ¶ 279. There are several important differences between these models, and AirTouch will likely comment on these differences in its comments related to the upcoming proxy cost model workshops. *See* "Federal-State Joint Board on Universal Service: Staff to Hold Workshops on Proxy Cost Models on January 14-15, 1997," CC Docket No. 96-45, DA 96-2091 (rel. Dec. 12, 1996).